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Nos. 87-976, 87-977, 87-979

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

TEXAS EASTERN TRANSMISSION CORPORATION,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

CITY OF WILLCOX, ARIZONA, *et al.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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APPENDIX TO BRIEF IN OPPOSITION OF EXXON CORPORATION AND CONOCO INC.

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APPENDIX

Excerpts from FERC Order No. 436, 50 Fed. Reg. 42408 (1985) (footnotes omitted except as indicated)

[corrected to reflect FERC's Order of October 24, 1985, 50 Fed. Reg. 45907]

[50 Fed. Reg. 42409]

Final rule

Issued October 9, 1985.

I. Introduction

A. The Proposed Rule

On May 30, 1985, the Federal Energy Regulatory Commission (Commission) proposed changes to its regulation of natural gas pipelines after partial wellhead decontrol of gas on January 1, 1985. The May 30 Notice of Proposed Rulemaking (NOPR) was the outcome of a five-month notice of inquiry begun in this docket on December 24, 1984. The Commission is issuing its final rule in order to comply with the Natural Gas Act (NGA), the Natural Gas Policy Act of 1978 (NGPA), and the mandate of the court in *Maryland People's Counsel* v. *FERC*, Nos. 84-1019, 84-1029 and 84-1090 (D.C. Cir. 1985).

The NOPR proposed significant changes to our regulation of natural gas pipeline companies in light of the many changes in the natural gas industry over the years. These changes have included the NGPA which immediately removed market entry and exit restrictions over "first sales" of all new supplies of natural gas (NGPA section 601(a)(1)) and which removed wellhead price controls on the majority of gas supplies on January 1, 1985, pursuant to the Congressionally-mandated schedule (NGPA section 121).

* * * *

[50 Fed. Reg. 42411]

C. Statement of Commission Purposes

As will be detailed in this Preamble, the natural gas industry has changed significantly since Congress adopted the NGA in 1938 and indeed since adoption in 1978 of the NGPA.

Among the statutory responsibilities granted by Congress to the Commission is section 4(a) of the NGA which requires that all natural gas rates and practices subject to the jurisdiction of the Commission shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful. Section 5(a) of the NGA gives the Commission the power, after hearing, to determine the just and reasonable rate or practice and to fix the rate by order.

Section 7(e) of the NGA authorizes the Commission to condition certificates for services and facilities in such manner as the public convenience and necessity may require. Section 7(e) grants the Commission broad power because such certificate and conditioning authority is the means by which the Commission effectuates the purpose of the NGA to underwrite just and reasonable rates to the consumers of natural gas.

However, what Congress has given, Congress can take away. In 1978, Congress did just that when it enacted the NGPA. The NGPA expressly removed the Commission's NGA jurisdiction to establish just and reasonable rates *at the wellhead* for new gas supplies not committed or dedicated to interstate commerce prior to enactment. The NGPA also severely limited the Commission's jurisdiction to review the purchase costs of such new gas by pipelines at the city-gate. The NGPA, however, did not remove or restrict the Commission's remaining NGA jurisdiction and the responsibility to establish just and reasonable rates for the transportation of all categories of gas in interstate commerce, or for the sale of natural gas committed dedicated to interstate commerce prior to enactment.

In essence, sections 601 and 121 of the NGPA effected a phased partial reversal of the Supreme Court's 1954 decision in the *Phillips* case (holding that independent producers are "natural-gas companies" when they make field sales of natural gas to interstate pipelines for resale). Section 601 removed all NGA jurisdiction over "new" gas, effective December 1, 1978, while section 121 removed NGPA price controls over specified gas supplies, effective November of 1979, January 1, 1985 and July 1, 1987.

These statutory changes reflect a Congressional determination that producers of natural gas do not have "natural" monopoly power. In other words, the statute reflects the workably competitive nature of the production industry.

Moreover, as a result of physical and technological changes that have taken place as the industry has grown and matured over the last fifty years, a given supply of the natural gas commodity can now be transported—by front haul, back haul, exchange or displacement—to points throughout the continental United States. As a result, as a technical matter, producers of natural gas can market their supplies in an essentially national market while individual customers or resellers of gas (such as the local gas utilities) can obtain supplies from a variety of sources.

These legal and technical changes have already begun to restructure the industry.

The Commission's overriding goal in this docket is to adapt our regulations to these fundamental legal and technical changes so that we may continue to fulfill our statutory mandates under the NGA and the NPGA. Thus, the final rule adjusts, within the scope of the authority delegated by the Congress, those aspects of our current regulations that now appear to hinder the development of competition in those areas where competition will better protect the public interest than will tradi-

tional public utility regulatory rules. The final rule retains the traditional regulatory approach in areas where it is needed to protect the public from market dominance by natural gas companies.

The purpose of the final rule is to assure that commodity and transmission prices for natural gas between the wellhead and burner-tip are clear and accurate and consistent with the requirement of the NGA that rates and practices be just and reasonable and not unduly discriminatory, or preferential. The final rule also secures to consumers the benefits of competition in natural gas markets consistent with both the NGA and the NPGA. The final rule achieves these goals by establishing a framework for setting just and reasonable rates and practices for the sale and transportation of natural gas in interstate commerce, and by reasonably conditioning self-implementing interstate transportation services under the NGA and the NPGA.

Accordingly, in light of the record of comment and experience detailed herein and pursuant to sections 4, 5, 7 and 16 of the NGA, sections 311 and 501 of the NPGA and sections 402 and 403 of the DOE Organization Act, the Commission is issuing the present final rule.

* * * *

[50 Fed. Reg. 42412-15]

II. Background and Discussion

A. Changes in the Industry and the "Unbundling" of Natural Gas as a Commodity

1. *The change in a nutshell and the Commission's overriding goal.* The natural gas industry has changed in fundamental ways over the nearly 50 years since the Natural Gas Act was adopted in 1938. The changes have been accelerated over the last seven years by the phased

removal of wellhead price controls under the Congressionally mandated schedule set out in the Natural Gas Policy Act of 1978.

In a nutshell, the single most important economic change has been that natural gas has become a separate and distinct economic *commodity*: distinct from oil, distinct from transportation, and distinct from storage and various load balancing services. Around the commodity has evolved a highly competitive and rapidly growing spot market, with a thriving infrastructure of brokers and marketers, electronic information exchange services, and trade publications tracking price and market movements. Moreover, the Congressional decision in the NGPA to remove both price (NGPA section 121) and non-price (NGPA section 601(a)(1)) regulation over "first sales" of most natural gas—whether in interstate or intrastate commerce—has meant that these supplies of gas can now generally be sold by producers or marketers without the need for prior regulatory approval of market entry, market exit or price.

With regard to the availability of interstate pipeline *transportation*, the situation has also changed in significant ways. There are some geographic areas where there is but a single pipeline supplier, as was the case for the vast majority of markets in 1938. But in many other markets, there are two or more pipeline suppliers capable of serving a customer. The presence of pipeline-to-pipeline competition in these markets has radically altered the role of the Commission as well as the ability of utility-type regulation to tightly control regulated price levels.

Moreover, the maturing of the pipeline industry in recent decades has meant that there is now an interconnected nationwide pipeline grid. This enables increasingly efficient transportation transactions through backhauls, displacement and exchanges, enabling the "transportation" of a particular supply to a particular pur-

chaser who is far removed from the supply and indeed may not even be directly physically connected with the field supply source. Thus, even where a pipeline is the only supplier to a given customer, that customer—given non-discriminatory access to the transportation service and proper rate treatment for all pipelines—has access to supplies of the *commodity* located in virtually any producing area in the Nation. Conversely, a producer of gas can now—given the same non-discriminatory access to the *transportation* grid—seek markets for his gas virtually anywhere in the Nation. As is demonstrated later, this is not economic theory but bustling commercial reality.

Finally, there is the question of capacity. While it is true that pipelines generally continue to be fairly fully utilized during peak period operations, total deliveries through their systems have fallen sharply from the 1972-1973 period. This is illustrated in Chart 1 below. [Omitted.]

This phenomenon has been reflected in lower annual load factors for interstate pipelines and higher *unit* costs of providing service. It has also meant a significant increase in the amount of capacity available for transportation outside of the periods of peak demand. The chart further indicates that pipeline utilization for sales during the peak winter period has remained high and indeed has even increased. This indicates that firm capacity is generally being utilized on peak by those customers who have contracted for (or "booked") such service.

In short, the Commission is confronted with:

(1) A generally competitive market in the *commodity* of natural gas, most of which has been removed by Congress from all federal regulation as to market entry, exit and price, although such regulation has been retained by Congress over substantial amounts of gas; and

(2) A highly integrated *transportation* network, highly monopolistic in some markets, fairly competitive in others; over which Congress has generally determined to retain utility-type regulation over market entry, exit and price; but for which Congress has also allowed an alternative approach (under NGPA § 311) in which there may be no restrictions as to market entry and exit, but for which Congress expressly retained regulation as to rates.

Thus, in the words of one recent court decision:

> In its oversight of the natural gas market, FERC confronts baffling problems.

But these problems are not unique to the natural gas industry. Nor are they insurmountable. What is required is to adapt our regulatory framework to the changed circumstances in order to implement our statutory responsibilities in ways that further Congressional goals of the lowest reasonable rate for natural gas customers consistent with reliable, long-term service.

Accordingly, our overriding goal in this docket is to adjust our regulatory framework for natural gas in ways which:

(1) Retain and revise utility-type regulation over the interstate *transportation* function—that function which the Congress has deemed sufficiently uncompetitive so as to require such regulation in the public interest—yet

(2) Allow the *commodity* market for natural gas to continue to develop in a competitive fashion.

In this way, regulation will allow competitive forces to operate in those areas where Congress has determined they will better protect the public interest than traditional utility-type regulation, while retaining the traditional-type regulation in those areas where competitive forces have been found inadequate by the Congress.

To do this, the final rules generally seek to provide additional market options for suppliers, pipelines and customers. Thus, where a pipeline offers *transportation* as an "unbundled" service, the customer will be able to purchase *gas* in what Congress has determined (and which experience increasingly demonstrates) to be a workably competitive market. The terms and conditions of that transportation service remain fully subject to regulations under the NGA.

Moreover, where an interstate pipeline offers a "bundled" service in which the gas commodity is offered only as part of a package of services which includes a transportation component, the Commission presently concludes that the potential for market dominance by the pipeline is so great that more traditional utility-type regulation is required to satisfy the Congressional mandate set out in the NGA.

The various components of the final rule are designed to implement these general goals. In promulgating this rule, we are mindful of our obligation "to take into account what is known as to past experience and what is reasonably predictable about the future." Accordingly, the remainder of the preamble sets forth in some detail the factual, logical and legal bases for the above conclusions and explains how the final rule will operate to advance these goals.

2. *Natural gas is a separate commodity from oil.* At the time of enactment of the NGA, natural gas was primarily a by-product of oil production. According to the Federal Trade Commission Report of 1935, approximately 60 to 70 percent of all natural gas (including both associated and non-associated natural gas) was found as a result of exploration for oil.

Over the years, advanced exploratory knowledge and techniques gradually have made it possible for producers to explore for gas separately from crude oil. Prior to the development of such techniques, the natural gas re-

source base which supported the rapid expansion of gas use in the 1950's and 1960's had been developed for the most part as a result of drilling for oil rather than gas and the role of gas prices as an incentive for developing new gas reserves had been secondary. The advanced exploratory techniques sharply increased the importance of price as an incentive for further drilling of natural gas and helped establish gas as a separate economic commodity. Indeed this economic fact played a major role in the Commission's decision in 1965 to adopt two separate "vintages" of "old" and "new" gas, each subject to a separate ceiling price.

The key conclusion which flows from this fact is that *price* signals for natural gas play the same role in stimulating or dampening supply as they play in other commodity markets. Accurate, responsive price signals are thus not a matter for mere academic concern but a matter of commercial life and death for the production industry.

3. *Development of the transmission grid.* The interstate natural gas transmission industry has matured over the last 50 years, developing from a series of essentially individual, separated systems into an extensive integrated transportation grid.

In 1935, when the Federal Trade Commission completed its exhaustive study of the industry, interstate natural gas pipeline companies were largely separate systems, dependent on a few fairly well localized sources of supply. This is well illustrated by the attached 1934 map of the industry and by the FTC's detailed discussion of each of the industrial systems.

The industry of the time was succinctly described by the FTC Report:

> The function of transmission or transportation of natural gas in bulk over the long distances commonly required to market any considerable volume

of gas is, on the other hand, one of the least competitive situations to be found involving commodities or public utility service. There is no known method by which gas in large quantities can be transported except by pipe lines. Oil may be moved in pipe lines, tank cars, trucks, and water-floated barges or "tankers" and packaged in barrels and other small containers for transport by various means. Most, if not all, commodities can be moved from points of origin to points of destination with a choice of routes, containers, and volumes to be handled at any one time.

Most, if not all, commodities, except electric power, may be accumulated in storage previous to, during, or following transportation and drawn from such storage to meet intermittent or variable quantity demands. Except for some incidental storage in pipe lines under considerable pressure, commercial storage of natural gas is inconsequential after it is withdrawn from the ground. Again the large investment of $20,000 to $35,000 a mile for the larger sizes of pipe in long pipe lines generally laid below the surface of the ground as contrasted with overhead wire circuits ($1,000 to $15,000 a mile) and various physical means of transportation of other commodities constitutes a barrier to direct competition in transportation through the installation of competing pipe lines by any but large-volume purveyors, which has led to a demand from the smaller producers that existing gas pipe lines be made common carriers obligated to transport gas of producers other than those affiliated with, or making satisfactory terms for sale with the owners of the pipe line.

Thus, even where opportunities for direct pipeline-to-pipeline competition were presented, the natural gas companies in the 1920's and 1930's generally preferred to enter a new market by way of joint ventures.

Over the decades the system has changed immensely. Even superficially the development of a farm [*sic*] more integrated system is readily apparent as illustrated by the attached 1982 map.

Moreover, the integration of the system is vividly illustrated by the increase in the amount of gas which interstate pipelines transport or exchange for each other (Table I below) and by the increase in costs incurred by pipelines in purchasing transportation services from other pipelines (Table II below).

The storage situation has also changed completely. Whereas the FTC in 1935 found commercial storage to be "inconsequential," storage now plays an integral role in the industry. As indicated by Table III below, the amount of storage capacity has continued to increase over the years. [Tables omittted.]

The availability of this storage capacity means that gas does not have to be produced and consumed at identical rates (with resulting reliance either on shutting in of production in field or in "dump" sales of gas in markets). Rather, delivery of volumes can be taken in many instances even where there is no immediate use for the gas. Operational constraints remain a limitation, of course. But operational flexibility has increased enormously.

This is also reflected in changes in corporate structure. Thus, we note that the recent mergers and acquisitions have given the companies involved much greater operational flexibility. These mergers have allowed companies access to new markets, to new sources of supply, as well as to storage capabilities.

* * * *

[50 Fed. Reg. 42418-19]

5. *Congress has recognized the existence of a workably competitive wellhead market, and has removed Federal controls over market entry, market exit and price*

for new gas. With regard to all new supplies of natural gas, comprising about one-half of all [*sic*] gas at present, the Congress in the NGPA removed all regulatory controls over market entry (NGA section 7(c) certification) market exit (NGA section 7(b) abandonment) and price (NGPA sections 102-109 and section 504). See NGPA section 121 and section 601(a). Indeed, in NGPA section 601(c) Congress removed from the Commission any power to prevent interstate pipelines from "flowing through" to their customers the costs of purchasing the gas commodity absent "fraud and abuse or similar grounds."

Thus, in the words of one court:

> The NGPA is a fundamental change in regulatory outlook. Contrary to the Supreme Court's assumption in *Phillips Petroleum Co. v. Wisconsin*, 357 U.S. 672, 74 S.Ct. 672, 98 L.Ed. 1035 (1954), which subjected gas producers to utility-type regulation under the NGA, Congress apparently decided that gas producers do not have "natural" monopoly power; that is, the industry does not possess the inherent technical characteristics that prevent its efficient and economical operation unless operated as a monopoly.[36] Therefore, the theory that a regulatory agency is necessary to represent consumers when they bargain on rates with a natural monopolist like a utility no longer applies to gas production. *See generally* Goldberg, Regulation and Administered Contracts, 7 Bell J. Econ. 426 (1976).

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[36] *See* J. Bonbright, Principles of Public Utility Rates 10-13 (1961). The congressional assumption concerning lack of producer natural monopoly power is evidenced in the phased deregulation of wellhead prices and the elimination of FERC regulatory control under the NGPA over gas eligible for § 601(a)(1). The continuation of price controls on older, cheap gas reflects only a concern about preventing financial windfalls to sellers with very low-cost gas properties, and not a concern about natural monopoly power.

As a direct result of the NGPA, for example, a natural gas producer can now sell "new" gas to any purchaser—an intrastate pipeline, an interstate pipeline, a local distribution company served by an intra- or interstate pipeline, an end-user, a non-profit consumer cooperative or what have you—without federal restrictions as to market entry, market exit or price attaching to the sale. Similarly, an independent marketer can acquire a portfolio of gas purchase agreements and sell gas supply to any person, again without coming under any market entry, market exit or price regulation over the sale. In short, with respect to sales of the commodity by producers or marketers, Congress removed controls in recognition of the competitive nature of the commodity market for gas.

An interstate pipeline, however, seeking to sell gas from its system supply (a commingled stream of gas that was at the wellhead both NGA-jurisdictional and NGA-non-jurisdictional) is subject to the full panoply of statutory regulation governing market entry, market exit and price. As a result, *even for already certificated sales to existing customers*, it may change its rates only upon 30 days advance notice. It must supply extensive documentation detailing each and every source of natural gas supply, including an identification of the seller, the location, and the price. If it seeks to provide a new service to an existing customer, it must file for and obtain a section 7(c) certificate authorizing the new service. Any party opposing the new market entry has a right to explore genuine issues of material fact in a contested, trial-type hearing.

The rationale for maintaining utility-type market entry, exit, and price regulation over the sales for resale of interstate pipelines while removing that regulation for similar sales by other market entities is only implicit in the NGPA but appears plain enough: While Congress concluded that gas production was sufficiently competitive to remove regulation, the control which interstate

pipelines exercised over transportation still conferred on them the same kind of market power over their customers as had existed at the time of enactment of the NGA.

If customers had access to transportation for gas which they purchase directly in the competitive, commodity market, the pipeline would find itself at a serious competitive disadvantage in marketing gas in competition with producers and other entities because the regulatory rules as to market entry, exit and price would deprive it of the flexibility to meet the competition. We have *already* seen a good deal of that with the development of the spot market, the resulting decline in pipeline sales and increased use of transportation. And with the advent of repeated out-of-cycle PGA filings, we have seen what may be the beginnings of a virtual "posted price" approach to gas at the resale end where pipelines compete against other pipelines.

Yet a pipeline that accepts the open access condition tendered in the final rule will have agreed to provide its customers with that access, thereby accelerating the process. This would thus require those pipelines that wish to remain merchants to seek greatly increased pricing flexibility.

* * * *

[50 Fed. Reg. 42420-21]

B. The Problem in a Nutshell

The NGPA certainly accomplished its primary goal of increasing competition and gas supplies at the wellhead. But the NGPA also aggravated price distortions between the city-gate and the wellhead. These price distortions have intensified competitive pressures on pipelines for new and lower-priced services. In turn, these competitive pressures require changes in the Commission's regulations if we are to fulfill statutory regulatory obligations over interstate pipelines in turbulent and fast-changing gas commodity markets.

The problems created by the NGPA are inextricably intertwined with the Commission's administration of its remaining jurisdiction under the NGPA.

To the extent the NGPA removed the Commission's NGA jurisdiction over certain wellhead gas markets, the Commission is powerless to "turn back the clock" and restore that jurisdiction, no matter what problems and "disorders" have arisen in those markets since the NGPA.

To the extent the Commission exercises its remaining NGA jurisdiction so as to thwart the competitive commodity market for gas contemplated by the NGPA, the Commission may be negating one of the primary Congressional mandates of the NGPA.

The Commission has no choice in the matter; we are required to live within the letter and spirit of both the NGA and NGPA as Congress has directed, and we must reconcile the two in changing circumstances—in terms of surplus as well as times of shortage.

The NOPR summarized the current problems. The comments received in response generally support the Commission's analysis of the problem (if not necessarily all of the proposed solutions).

1. Prior to January 1, 1985, many interstate pipelines contracted for more gas supply than they could market at the prices set forth in those contracts, and do not intend to resume contracting for less expensive new gas reserves until their existing high-cost contracts are terminated or renegotiated to marketable levels.

2. Producers of gas, responding to very high prices and high "take-or-pay" terms bid by pipelines for small supplies of gas deregulated following enactment of the NGPA in 1978, have developed new supply sources of gas. But gas demand has fallen off since 1981 due to recession and lower oil prices, and the market today can-

not absorb these supplies at prevailing prices, even if "rolled-in" with cheaper "old" price-controlled gas. A surplus of gas deliverability has been created, resulting in many wells of all vintages being shut-in. In response, producers—particularly independent producers—are seeking equal and open access to pipeline transportation as an alternative to pipeline sales for marketing their gas.

3. Interstate pipelines, particularly those with larger quantities of "old" price-controlled gas to "roll-in" with more expensive "new gas" supplies—as well as intrastate pipelines under their limited interstate transportation and sales authority granted by section 311 of the NGPA—are seeking new markets and lower prices for both surplus gas supplies and surplus pipeline capacity. Pipelines are especially seeking new sales to new or existing fuel-switchable or pipeline-switchable customers, such as industrial boiler fuel users or partial-requirements customers.

But the existing interstate and intrastate customers of the pipelines are concerned that so-called "off-system" sales and "special marketing programs" will effectively transfer to the new customers a portion of the economic rent associated with the price of old, price-controlled gas when it is "rolled-in" with other, higher-priced supplies. Reflecting these same concerns, the Commission generally has allowed these alternative sales and marketing programs only under somewhat restrictive conditions or on an experimental basis.

In the case of the experimental "special marketing" programs" [*sic*] and the "blanket certificate" transportation programs for fuel-switchable end-users, pipeline customers have successfully challenged and overtruned [*sic*] the programs on judicial review on the ground they arbitrarily exclude other customers without consideration of the impacts on competition.

On the other hand, the Commission has promulgated a final rule which prohibits pipelines from recovering, in minimum commodity bills, the variable costs for gas not purchased by its customers. The rule has been sustained on judicial review on the grounds it permits partial requirements customers to "shop around" for gas supplies from other pipelines on a competitive basis.

4. Purchasers of natural gas, seeing the availability of supplies in the field at prices below the rolled-in average cost of all gas, are seeking to purchase gas directly in the field and have it transported to the city-gate or burner-tip in competition with the system supplies which the pipeline retains under certain uneconomic long-term contracts. In so doing, purchasers of gas are seeking the same opportunities to "swing" back and forth among a balanced "portfolio" of natural gas supplies that "partial-requirements" customers currently enjoy, after implementation of the minimum bill rule, in "swinging" back and forth among competing pipeline suppliers.

5. The pipelines have generally expressed a reluctance to provide these transportation services on a non-discriminatory basis to their existing sales customers or to customers without immediate fuel-switching capability, such as residential and commercial consumers.

a. With respect to incremental volumes (*i.e.*, gas that would not displace a sale by the pipeline itself from its own contracted-for supply), pipelines generally do not have adequate incentives to provide this service as long as the pipeline's rate structure requires the crediting to the pipeline's sales customers of essentially all revenues received from the transportation. The regulations allowed the pipeline to elect an option pursuant to which costs would be allocated to the transportation service (allowing retention of the revenues), but until fairly recently most major pipelines had not elected that option. Moreover, the pipelines have been under no legal obligation to elect the revenue retention option. Once pipelines

began to design their rates to allocate costs to the transportation service, thereby obtaining the right to retain revenue, the ratemaking rationale for declining to transport incremental volumes has diminished.

b. With regard to volumes of gas that would displace a sale by the pipeline from its own contracted-for supply, the situation has been somewhat more complex.

(i) Where the pipeline's take-or-pay exposure was so great that it believed that prepaid gas wou'd never be able to be "made up," the pipeline faced the possibility of forfeiting the entire principal amount of the prepayment. Under these economic circumstances, even where the pipeline was able to retain the revenues received from providing transportation, the pipeline would still lose money were it to transport gas that would displace a unit of contracted-for gas. The more gas it transported, the more money it would lose. Under these circumstances the pipeline's reluctance to transport was at its height. Accordingly, it is important to provide flexibility for pipelines and producers to renegotiate these contracts, to review "buy-outs," "buy-downs" and to provide for expedited treatment of limited term and permanent producer abandonment and certificate requests.

(ii) Where the pipeline's take-or-pay exposure was *not* so great as to confront it with the prospect of forfeiting prepayments, the question was more one of fixed cost allocation. If the pipeline had to finance the prepayments, who should bear the burden of the carrying charges, the fixed costs associated with the prepayment: the sales customers, the transportation customers, the producer (by not being paid in accordance with the contract), or the pipeline's share-holders?

6. As a result of the pattern of contractual arrangements developed by the industry during previous eras of pipeline expansion and supply curtailment, such as take-or-pay and minimum bill provisions, customers of

pipelines have been allocated a large part of the risk that gas supplies deregulated by the NGPA might prove unmarketable over the life of contracts signed by producers and pipelines.

In turn, the Commission's administration of its ratemaking and certificate obligations under the NGA has impeded the ability of natural gas consumers to secure the rewards of competition in natural gas markets commensurate with the risks that have been allocated to them by pipelines and producers.

In particular, the Commission's policy of full rolled-in pricing of price-controlled and deregulated gas supplies has frustrated the transmission of clear and accurate price signals between the city-gate and the wellhead, and has permitted pipelines to bid up new gas prices above market-clearing levels.

The Commission's policy of discouraging the flexible entry and exit of new pipeline services from natural gas markets is thwarting the expansion of the interstate pipeline system in order to provide for changing end-uses of gas and changing locations of new gas fields.

7. As a result, average delivered prices of gas are not adjusting downwards in line with the decline in field prices, and this failure is causing unnecessarily high energy costs to consumers and a very large loss to the American economy in jobs, production, and net economic efficiency.[100]

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[100] Comments of DOE at 3, 6, estimating proposed rulemaking, if adopted, could have net economic benefits of $1.2 to $4.9 billion (non-discriminatory transportation) and $2.2 billion (block billing procedure); Process Gas Consumers at 13 (*citing* DOE estimate that lack of non-discriminatory transportation has adverse-economic effects of $9.7 billion annually), and 14-16 (discussing example of impact on specific manufacturing plants of lack of access to transportation services); *Second DOE 123 Report, supra* at Appendix B, Examples of Anticompetitive Behavior in Gas Transmission.

Accordingly, the Commission has determined to make the changes set out in today's rule. We turn now to a detailed analysis of the comments filed in this docket.

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[50 Fed. Reg. 42421-22]

A. Whether To Issue Any Final Rule

Comments. The majority of commenters commended the Commission for moving forward to address the problems of the industry on a generic and expedited basis. Many of these commenters echoed their comments filed in the earlier Notices of Inquiry phase as well as in earlier petitions, complaints, judicial decisions, and Congressional directions before the Commission. These commenters also generally urged the Commission to act with dispatch to issue a final rule in this docket during the current conditions in gas markets.

However, several commenters urged the Commission to consider issuing no final rule, or else to issue a final rule governing transportation and the optional certificates while delaying a final rule on other parts of the proposed rule, such as the billing procedure. Several requests were received urging the Commission to provide for further public comment on the billing procedure.

For example, some commenters pointed to the fact that delivered gas prices have remained flat for several months and suggested that gas markets were adequately adjusting to partial wellhead deregulation after January 1, 1985; therefore, the Commission's proposed rule was unnecessary except where required in response to court remand. Other commenters suggested that the Commission address its regulatory obligations on a case-by-case basis rather than by rule, or suggested that in any case the Commission's proposal was administratively unworkable.

Commission Response. The Commission initiated the proceedings in this docket over nine months ago. As a

practical matter, however, these proceedings also owe their origin to nearly seven years of Commission and industry experience in attempting to reconcile the NGA and the NGPA in rapidly changing gas markets which have been described as "disordered" and "chaotic." In response to our notices, we have received close to 200 comments in the NOI phase of the proceeding and 300 comments on the proposed rule, aggregating a record of over 10,000 pages. Some one hundred and fifty parties participated in four days of public conferences on the NOI and in two days of hearings in response to the NOPR.

In considering the alternative of taking no substantial action, the Commission has reviewed those comments and the actual experience under the present regulatory framework as detailed in Section II above. That record of comment and experience demonstrates conclusively that the natural gas industry has undergone radical changes in its structure and markets and that the regulatory framework must also be changed. Issues relating to gas-on-gas competition, access to transportation, pipeline and local distribution company "by-pass," prudency of pipeline "high-cost" gas purchases, persistence of "take-or-pay" problem contracts, shut-in of gas supplies, restrictions on entry and exit from the gas business, and allocation of fixed costs are arising with increasing frequency in filings before the Commission. (See Exhibit B showing out-of-cycle PGA filings). For reasons of administrative economy and predictability alone, the Commission could determine to deal with these issues by rule.

However, a much more compelling reason exists for the Commission's rejecting the alternative of issuing no final rule today: we have no choice under the NGA.

Section 5(a) of the NGA is mandatory, not discretionary. Once the Commission finds that an existing rate or charge or practice is unjust, unreasonable, or unduly discriminatory, it must prescribe the remedy for that

situation. Moreover, the Commission also has an obligation under the NGA to weigh and consider the competitive effects of our decisions, especially where, as here, the Commission's regulations relating to the transportation of natural gas have been held to deviate from fundamental protections intended by the NGA.

As detailed here, the Commission has found that certain aspects of the present regulatory framework are allowing rates, charges, and practices which are unjust, unreasonable, and unduly discriminatory under section 5 of the NGA. In addition, the Commission has considered the competitive effects of certain of its regulations and is adjusting those regulations in order to assure that the benefits of new competitive pressures in natural gas markets are secured to all customers consistent with the NGA.

The continued persistence of a large "bubble" of surplus gas deliverability (Exhibit L) during a period of sustained recovery in the general economy demonstrates vividly the distortions created under the present regulatory framework. Moreover, the depressed state of the domestic drilling industry, now into its fourth year (Exhibits M and N), reflects the surplus of current supply but also may raise some concern as to how quickly drilling may accelerate as the surplus is dissipated. If producers are to increase drilling at the appropriate time and in efficient amounts, they *must* have more accurate price information than has been the case in the past.

One key to those more accurate prices is equal and open access to burner-tip markets. In turn, this access can only be realized if the ratemaking and certificate standards for interstate transportation are structured appropriately. This is what we have endeavored to do in Parts A and C.

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[50 Fed. Reg. 42422-23]

B. Whether To Serve Out Parts A and C

Commission Response. The Commission has considered whether to adopt such a "piecemeal" approach and issue only the transportation components of the rule. The issue in this regard is whether the identified problems and the proposed solutions (or rather mitigating measures) "are so inextricably related . . . that simultaneous resolution of the issue is required." In this regard, we are well aware of the fact that a major criticism of the minimum bill rule was that the Commission had engaged in irrational "piecemeal reform" by acting at the downstream nexus rather than upstream at the wellhead.

We understand the surface appeal of dealing with transportation issues alone:

- The strong mandate of the court decisions on SMPs and especially blanket transportation certificates, calling for a non-discriminatory approach to implementing interstate transportation; and

- The concern over the expiration of these programs effective November 1, 1985.

But we have concluded that many of the residual problems in the industry to a large degree *are* "inextricably related."

(1) Increased access to transportation on a non-discriminatory basis will place a pipeline in the position of competing as transporter with itself as merchant. An increase in transportation volumes inevitably exposes the pipeline to the risk of a decrease in its sales. Hence, we need to address such issues as the circumstances under which a pipeline can buy out of its wellhead contracts and the questions of how a producer that remains subject to NGA jurisdiction can obtain *regulatory* approvals to market gas which the pipeline is willing *contractually* to release. The new transportation rules are thus tied to the April 10, 1985 Policy Statement and the provision for expedited review of producer abandonment filings.

(2) Moreover, how does a pipeline customer make an informed judgement as to whether to buy gas from the pipeline or to convert to some amount of reserved transportation and buy gas from an alternative merchant *unless* the pipeline's sales price for gas reflects more accurately the cost to the customer of alternative purchases? Thus, the ultimate efficacity of the transportation rules is linked in part to the whatever final resolution is adopted to address the distortions of rolled-in pricing.

(3) How can a sole-supplied customer gain access to the competitive *commodity* market unless he can gain access to firm transmission capacity, *e.g.*, through the "unbooking" of already contracted for capacity via the CD reduction option and through the conversion option? Thus, the viability of the transmission rules (as well as the presumption of justness and reasonableness proposed in the revised Part D) is tied into the CD adjustment options of section 284.10.

(4) If the commodity market is to *remain* competitive even after the present excess of gas inventory is "worked off," (and even if the current move towards corporate consolidation continues), then the regulatory framework must be structured in such a way that unbundled transportation will continue to be available. Thus, pipelines must bear more of the risk of underutilization of their transmission facilities than is the case when all costs are recovered from sales customers and with transportation revenues being credited to other customers rather than retained by the pipeline. Only in this way will the regulatory framework provides [*sic*] adequate linkage between the allocation of economic risk among industry participants and business control over those risks.

(5) "Conscious parallelism" is easiest to pursue in a market with a very small number of participants. While such activity may not run counter to the antitrust laws, it certainly is not to be encouraged. A good way to help

police against such behavior in a regulated market is to make sure that current market participants cannot use the regulatory structure to exclude new competitors. Thus, the viability of the transportation rules is tied into the easier market entry contemplated by the optional expedited certificates.

In short, the Commission has concluded that changes are required in several different areas concurrently. This does not mean, however, that the present rule is expected to be a panacea, or that further action in other areas is necessarily foreclosed. Rather, the three components issued today, together with the revised proposal regarding Part D, reflect a first step—albeit a major one—towards adapting our regulations to the post-NGPA world.

Accordingly, in light of the inter-relationship of the parts and the significant changes made to respond to many of the problems identified by the comments, the Commission has determined to proceed with the broader approach reflected in the final rule, while at the same time calling for further comment on a revised proposal for block billing.

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[50 Fed. Reg. 42423-24]

C. Discussion of Other Alternatives

Since 1982, the Commission has considered a number of alternative approaches for dealing with the changes that have been be coming [*sic*] increasingly apparent in the industry. For example, we have considered:

- Setting new, just and reasonable rates for old gas;
- Establishing pipeline supply "cut-back" plans;
- Eliminating minimum commodity bills;
- Modifying the PGA regulations; and
- Encouraging broader access to pipeline transportation for others.

The first two options focus on the wellhead. Under the first, the Commission would raise the price of old gas under NGPA sections 104, 106(a) and 109 to "just and reasonable" levels. All aspects of this approach were aired in a Notice of Inquiry commenced in April of 1982 in Docket No. RM82-26. The advantages of such an approach are that it would provide increased incentives for development of lower cost gas resources and would mitigate the distortions created by full rolled-in pricing in combination with the "cushion" of "old gas." It would put increased downward pressure on spot prices, however, and on the price of all above-average priced gas supplies. It could also involve the Commission in a most intimate way in determining the "proper" supply mix as between old and new gas. In effect the exercise of such power involves the concomitant responsibility of setting rates for the commodity that are neither too high nor too low.

The experience of 1954 to 1978 speaks eloquently to the difficulties faced by an independent economic regulatory commission in attempting to discharge that responsibility. It is the Commission's tentative judgement that Congress, through its decisions to ultimately decontrol all natural gas supplies (as old gas is depleted), determined that the workably competitive wellhead market would do a better job of setting such rates for the commodity than would a utility regulatory body.

Much of the discussion in the comments on Part D of the May 30th NOPR repeats the comment and argument received in response to the 1982 NOI in Docket No. RM82-26. For example, the Indicated Producers stressed the importance of continuing rolled-in pricing and called for action to raise the price for old gas. Similarly, their 1982 comments asserted that shortages could be expected in the not too distant future unless action was taken expeditiously to raise old gas prices. The California Public Utilities Commission, on the other hand, in their 1982 comments, called for an end to full rolled-in pricing

and the institution of a form of separate pricing of all old and new gas. We anticipate that there will be a more refined analysis of these issues in response to our request for supplemental comments on the revised Part D.

With regard to the second basic approach, beginning in 1983, a number of interstate pipelines, distributors and state commissions of major downstream gas consuming states began urging the Commission to establish gas "cut-back" plans for interstate pipelines. In essence, they proposed for the Commission to order the pipelines as to which gas supplies should be taken and in which order. A list of these filings is attached as Exhibit R.

In many respects this option represents the "flip side" of the old gas proposal. Like it, the "cut-back" plan approach would involve the Commission ultimately in many aspects of natural gas production decisions. It would substitute the Commission's judgement for that of the commercial parties on such issues as which supplies of gas should be taken by a pipeline in managing its portfolio of gas purchase agreements.

But unlike the old gas proposal, the cut-back approach would lay the predicate for pipelines to assert to producers that supervening governmental action relieved the purchaser of all liability for breach of contracts that would otherwise exist. It would thus also raise extremely serious questions regarding the ability of private parties in the gas production industry to rely on private contracts as a tool for structuring basic economic relationships.

The potential effect of the Commission pursuing this option thus could well have been, by essentially a stroke of the pen, to void thousands of gas purchase agreements nationwide and to declare worthless some $7 billion worth of contract damage claims which producers might otherwise pursue against interstate purchasers. Neither the legal nor the factual basis for potentially voiding billions

of dollars in freely negotiated contracts was made clear in the filings made with the Commission. In addition, a determination that effectively abrogated non NGA-jurisdictional wellhead contracts would run directly counter to the Congressional directives in the NGPA that progressively removed federal regulation of producer-pipeline transactions, and which expressly allowed the free operation of those contracts where below any applicable maximum lawful prices prescribed by statute. See NGPA section 101(b)(9). See also NGPA section 601(c). Accordingly, the Commission has declined to pursue this path.

Moreover, the Commission has sought to make it crystal clear that *nowhere* in the final rules, including in the bilateral CD reduction and conversion options, has the Commission abrogated any contracts nor created a regulatory framework predicated on any unilateral contract abrogation. In short, while the Commission has the power to abrogate NGA jurisdictional contracts where required by public interest considerations, we have not invoked that power in these rules and revised proposed rules.

A third option considered over the last two years was to shift the regulatory focus "downstream," away from the wellhead, and to the nexus between the regulated pipelines and their customers. Here the Commission found minimum commodity bills and minimum take provisions—fully regulated contract provisions that impeded competition for the natural gas commodity and allowed for receipt of revenues by the regulated pipelines in excess of their costs.

The Commission determined in May of 1984 to limit the operation of these NGA-jurisdictional provisions. Through the summer and fall of 1984 appropriate proceedings were conducted and rules were promulgated to that effect. Those rules have since been affirmed in court.

During this same time period in 1984, the question of increased access to unbundled transportation was re-

viewed. The Commission heard oral argument in a case which illustrated vividly the conflicting interests involved in the issue and the interaction of the existing rate structure, certificate authority and the take-or-pay provisions which limited a pipeline's flexibility in dealing with requests for transportation that would displace its own sales.

In view of the inter-related nature of the problems raised, and the overhanging uncertainty raised by the approach of wellhead decontrol on January 1, 1985, no further action on the access question was taken at that time. Action on minimum bills, however, appeared sufficiently well defined so as to permit Commission action. This, of course, was the path the Commission chose. Experience since the August 1, 1984 effective date of the minimum bill rule has confirmed the powerful effects of competition among pipelines for sales to partial requirements customers. But as recognized by the Commission at the time, a major concern was with the potential for harm to customers that purchased all their gas supply from a single pipeline.

A fourth alternative course was to take action regarding pipeline PGA clauses. With the increase in competition, it seemed likely that PGA regulation might heed to be adapted to the impending arrival of partial wellhead decontrol on January 1, 1985. To review this option, the Commission issued a Notice of Inquiry in Docket No. RM84-12 (issued April 27, 1984). The general thrust of the comments received, however, was that no major changes were required in the PGA regulations, at least at that time. Accordingly, no rule changes have been proposed to date.

A fifth approach was to take action to encourage broader access to the competitive, wellhead market. As noted above, in 1984 the full Commission heard oral argument on a case that raised these issues. As it was apparent that further analysis of these complex issues was

required, no action was taken to allow time for further analysis and for developments in the industry to ripen. By the end of 1984, uncertainty over the likely immediate effects of partial wellhead decontrol were dissipating. On the other hand, a number of Sherman Act cases had been filed regarding access to transportation. Finally, experience under section 311 and the Order No. 234-B blanket certificate programs was indicating in a most concrete way the practical ability of the industry to adapt commercial practices to achieve the economic benefits of more open transportation. In short, events appeared to have progressed to where public comment on the issues, was appropriate. Accordingly, the Commission commenced its Notice of Inquiry in the present docket in December of 1984 and issued the NOPR in May. This, then, in conjunction with the minimum commodity bill rule already implemented, constitutes the thrust of the Commission's policies in this area of our jurisdiction.

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[50 Fed. Reg. 42424-30]

IV. Comment Analysis

A. Transportation

1. *Summary of final rule.*

a. Prohibition of undue discrimination in access to transportation.

Non-discriminatory access to self-implementing transportation services under section 7 of the NGA and section 311 of the NGPA is a cornerstone of the Commission's final rule.

Pipelines that provide transportation services on a non-discriminatory basis are assuring that the benefits of competitively priced gas supplies and transmission services are being made available to the broadest number of consumers. In addition, opening up transmission capacity

on an across-the-board basis helps to achieve a traditional utility ratemaking goal of maximizing throughput in order to spread fixed costs over the greatest number of customers.

On the other hand, permitting pipelines to unduly discriminate or to exclude certain consumers from transportation services is inconsistent with the fundamental goals of consumer protection and competition in the Natural Gas Act and the Natural Gas Policy Act. This is especially true where the Commission is authorizing pipelines to provide self-implementing transportation services to customers under section 7 "blanket" certificates or under section 311 authority.

The self-implementing nature of such services require the Commission to more carefully scrutinize and condition the certificates and agreements which underlie the services to assure that consumers are fully protected against discriminatory or unreasonable practices associated with the individual transportation arrangements that are being authorized prospectively without further Commission review.

The final rule adopts two complementary approaches in dealing with the question of non-discriminatory access.

(i) *Rate structures.* The rule modifies the ratemaking standards governing transportation for non-owner shippers. By requiring that costs be allocated to self-implementing transportation (§ 284.7(c)(4)) and that rates to recover those costs be based on projected units of services (§ 284.7(c)(2)), the final rule establishes a ratemaking framework within which the regulated company recovers its costs (including its allowed rate of return) by providing the regulated transportation service. Moreover, the rule provides for the use of reservation charges only for firm service (§ 284.8(d)) and forbids all other provisions that have the effect of guaranteeing revenue irrespective of the level of service actually provided § 284.8(c)(1), § 284.8(d) and [*sic*] 284.9(d)).

In addition, by reaffirming the Commission's April 10, 1985 Policy Statement regarding take-or-pay "buy-outs" and by providing for expeditious action on producer abandonment and certification requests, the final rule provides pipelines and producers with tools to deal with so-called problem contracts.

If we have designed these rate conditions properly, there should no longer be any real incentive for pipelines operating under the new rules to engage in denying access to "unbundled" transportation. Indeed, it may be more likely that the Commission will begin to receive complaints that the new rate conditions encourage a pipeline to attempt to transport *more* gas than it can or should. For example, one shipper may complain that a pipeline has accepted for transportation for another shipper a supply of gas with too many impurities or too low a heating content. Since the gas is commingled during transportation, the first shipper may complain that the gas redelivered to him no longer meets the quality specifications of the gas he delivered to the pipeline for transportation. But since the pipeline earned its fee simply by transporting the gas, it lacked an adequate incentive to refuse transportation to the inferior quality gas.

These kinds of problems can be addressed by the business participants, as they are in similar commercial contexts, through development of reasonable quality standards, quality "banking" services, market and price clearinghouses, etc.

Moreover, these problems are the kind of commercial problems faced in *any* properly functioning industry that deals in a reasonably fungible commodity of uneven physical qualities. By and large, it is reasonable to assume that most of these types of problems will be "sorted out" by the commercial parties without need for recourse to a utility regulatory body. The *regulatory* focus will be on cost allocations, projecting levels of services, determining cost of service (including rate of return) and similar

straight-forward utility issues, including ensuring that the transporting pipeline does not favor affiliates over other shippers.

(ii) Non-discriminatory access condition. While *theory* indicates that the rate conditions would preclude unduly discriminatory practices in most instances, experience teaches prudence. There may well be cases where a pipeline might nevertheless engage in discriminatory practices. For example, a pipeline might deny access to exclude a particular competitor from a given market or to disadvantage a shipper engaged in a manufacturing business in competition with a pipeline affiliate.

Accordingly, the rate conditions are complemented in the final rule by a broadly worded condition expressly prohibiting unduly discriminatory or preferential practices under the self-implementing transportation authorizations. See §§ 284.8(b) (regarding firm service), 284.9 (b) (regarding interruptible service) and 284.221(c) (subjecting blanket certificates to these conditions).

Thus, the final rule prohibits undue discrimination, or preference, including discrimination in the outright selection of customers. It also precludes more subtle forms of discrimination, such as adhering to the non-discriminatory standard within a customer class while establishing numerous customer classes. It prohibits discrimination among customer classes as well as on the basis of minimum volume requirements, the quality or duration of service rendered, the end-use to which the gas is put, or the type of gas transported.

Unjustified exclusion of shippers from transportation services is inconsistent with the mandate of the court in *MPC I and II*. Where a pipeline is authorized to transport gas on a self-implementing rather than a case-by-case basis, it is extremely difficult for shippers and the Commission to determine whether the exclusion of certain shippers by the pipeline is justified.

Examples of discrimination that the Commission finds to be undue or preferential within the context of the self-implementing authorizations are refusals to transport for existing sales or non-fuel switchable customers and preference for affiliates. On the other hand, the final rule makes clear that reasonable minimum operating and load management conditions imposed on shippers are not unduly discriminatory, or preferential, if imposed on all similarly situated shippers and if stated in filed transportation tariffs.

b. Increased Flexibility

The final rule is also intended to respond to the increased demand by pipelines and their shippers for increased flexibility and consistency in the Commission's regulation of transportation services. The final rule does this by eliminating restrictions on the categories of gas, shippers, end-uses, and duration of transactions eligible for self-implementing transportation. Pipelines seek this flexibility and consistency in order to respond to increased demands for transportation services by natural gas consumers, producers, and marketers.

c. Rates

Rates for self-implementing transportation by interstate pipelines must conform to specific standards set out in §§ 284.7, 284.8 and 284.9. Intrastate pipelines are not subject to these rate conditions. Interstate pipeline rates for self-implementing transportation must be volumetric and downwardly flexible between a maximum and a minimum. A reservation fee may be charged for firm service. See § 284.8(d). In order for pipelines to respond flexibly to market conditions between rate cases, rates below the maximum may be charged as long as they are not unduly discriminatory and are filed at the Commission. Such "rate discounting" must be solely at the pipeline's risk of under-recovery of costs; no pipeline is permitted to seek to recover such costs retroactively in future rate cases.

Such transportation service must be offered as a stand-alone basis, unbundled from any other services and separately tariffed. This precludes any tying arrangements between transportation and other services unless the bundled transportation services are offered as options to the stand-alone transportation service.

In order for pipelines to have the opportunity to earn rewards commensurate with any changes in their risks under the self-implementing program, pipelines are required to set projected levels for transportation service in rate cases. Costs will be allocated to be recovered through this service. Accordingly, a pipeline will be permitted to retain all transportation revenues collected for services rendered. Self-implementing transportation services by interstate pipelines are required to be offered on both a firm and interruptible basis, and capacity may be allocated by the pipeline on a first-come, first-served basis, subject to availability and without preference as between firm sales and firm transportation or between interruptible sales and interruptible transportation. "First-come, first-served" means the pipeline may offer transportation services subject to prior claims on capacity. Conforming rates under the new program must be filed to be effective no later than June 1, 1986. Any interstate pipeline that files for a blanket certificate under § 284.221 or that operates under authority of § 284.102 may charge existing transportation rates for self-implementing transportation services on an interim basis until the new rates are effective.

d. CD Reduction and Conversion Options

If an interstate pipeline chooses to provide self-implementing transportation under the final rule, it must also agree to provide its existing firm sales customers the option to convert their firm sales service to firm transportation service. As a condition of providing such firm transportation capacity, a pipeline may recover a portion

of its fixed costs by requiring its customers to pay a reservation charge not in excess of the fixed-costs in the demand charge allocated to the transmission component for firm sales service. The conversion option is detailed in § 284.10(d). In addition, a conditional opportunity is available to customers to reduce their firm sales contract demands or entitlements when their pipeline chooses to provide transportation services under the self-implementing program. See § 284.10(c). Pre-granted abandonment of its certificated service obligation would be available to any pipeline to the extent of any contract demand reduction, and no customer would have any right to resume firm sales service with the pipeline absent the issuance of a new or amended certificate to the pipeline required under section 7 of the NGA. See § 284.10(f).

The purpose of the reduction and conversion options in the final rule is to allow a "freeing up" of contracted firm capacity that customers no longer wish to reserve. This will allow that firm capacity to be contracted for by parties that do wish to purchase such firm service.

e. Transportation by intrastate pipelines

Because of the NGPA exemption of intrastate services from Commission jurisdiction under the NGA, intrastate pipelines that choose to transport under the self-implementing program are exempted from the rate conditions under § 284.7. Similarly, there is no requirement that the service offered by intrastate pipelines be firm. See §§ 284.8(a)(2) and 284.9(a)(2). Finally, intrastates would not be subject to the CD reduction and conversion options.

f. Grandfathering certain transactions

Transportation arrangements under previous section 311 programs and blanket transportation certificates under certain conditions, may continue beyond November 1, 1985, in order to allow a suitable transition period for the old programs to terminate and the new program to

begin without a break in services to consumers consistent with the final rule. Thus, even where a pipeline does not ultimately elect to continue to provide service under the non-discriminatory access condition of the new rules, existing blanket certificates and section 311 authorizations will allow transportation to continue during the transition period. Existing 311 arrangements will be permitted to continue until the expiration of their original term or extended term or October 9, 1987, whichever is earlier. Blanket transportation for high priority end-users under existing § 157.209(a) may continue until the expiration of their terms. Similarly, transportation for low priority end-users under § 157.209(e) may also continue subject, however, to the non-discriminatory access condition.

g. Individual certificates

Finally, the final rule does not apply a generic, non-discriminatory access condition to individual transportation and sales certificates under section 7 of the NGA. The consistency of such certificates with the purposes of this final rule can and will be reviewed by the Commission on a case-by-case basis at the time such certificates are sought.

h. Overview of comments

Commenters on the Part A transportation program raised several major issues. Among these issues were the scope and authority of the non-discriminatory access condition and its applicability to intrastate pipelines and to pipeline operational or load management conditions imposed routinely on shippers. Also raised as issues were the scope of and authority for conditioning availability of self-implementing transportation on a pipeline's agreeing to allow its customers to convert firm sales services to firm transportation service or to simply reduce contract demands. These comments also addressed the re-

allocation of risks and revenue responsibilities that would be required when customers adjust their contract demands. Commenters also addressed the authority and design of the downwardly flexible transportation rates and the quality of service requirements for firm and interruptible transportation services. Finally, commenters addressed the transition between current programs and the new transportation program established by the rule.

These comments and others are discussed in detail below.

2. *Commission authority to prescribe the non-discriminatory access condition.* a. Authority to impose on interstate transportation by interstate pipelines. The proposed rule provided that self-implementing transportation authorization under section 311 of the NGPA and blanket transportation certificates issued under section 7 of the NGA would be subject to an express non-discriminatory access condition. The express condition provided that any interstate or intrastate pipeline that provides any transportation service pursuant to such authority or certificate shall provide such service for all shippers willing to pay the applicable tariff rate on file with the Commission for the service requested, without discrimination in the quality of service provided, the categories, prices, or volumes of natural gas transported, customer classification, or discrimination of any kind.

Comments. Some commenters misunderstood the non-discriminatory access condition to require that *all* self-implementing transportation requests, including patently unreasonable requests, be accepted by transporters.

Commission Response. This was not the Commission's intent. Therefore, the non-discriminatory access condition has been revised in the final rule to insert the word "undue" to track the NGA statutory standard. The final rule thus is intended to prohibit undue discrimination, or

preference, including but not limited to undue discrimination or preference in the quality of service; duration of service; categories, prices, or volumes of gas transported (including as between affiliated and non-affiliated producers or shippers); and customer classification (including whether or not transportation would displace sales to an existing sales customer of the transporting pipeline).

Moreover, the final rule expressly provides that a pipeline may impose reasonable operational conditions on any request for self-implementing service. See §§ 284.8(c) and 284.9(c). Such conditions are required to be made a part of the pipeline's tariff, however, and thus will be subject to public scrutiny and Commission review. *Id.*

Comments. Most of the commenters who address the non-discriminatory access condition support the Commission's proposal. Those in favor of the proposal include a quarter of the major interstate pipelines, nearly half the intrastate pipelines, a majority of local distribution companies (LDCs) and virtually all industrial end-users, producers and public entities. The majority of interstate and intrastate pipelines oppose the proposal.

Those in favor of the non-discriminatory access condition generally state that it is necessary in order to effectuate the consumer protection and competition goals of the NGA and NGPA. They assert that it is reasonable in light of the increased demands for transportation of lower-priced gas in natural gas markets, and that it should be clearly stated and broadly applied in order to avoid evasion by pipelines on a case-by-case basis. They conclude that the Commission has legal authority to impose the condition.

The majority of commenters support the application of the non-discriminatory access condition to pipelines that choose to participate in the Commission's self-implementing transportation programs. They generally indicate the view that the Commission has sufficient authority to im-

plement the non-discriminatory access condition under both NGA section 7(e), which grants the Commission authority to attach reasonable conditions to certificates, and NGA sections 4(b) and 5(a), which prohibit undue discrimination or preference in rates, charges, or practices.

Among the cases cited in support of the Commission's authority under the NGA to impose the non-discriminatory access condition are: *Gulf Oil Corporation v. FPC*, 563 F.2d 588, 596-97 (3rd Cir. 1977) and *American Trucking Association, Inc. v. Atcheson, Topeka, & Santa Fe Railway Company*, 387 U.S. 397 (1967). Process Gas Consumers Group (PGC) also cites several cases in which the courts have read NGA section 7 very broadly to uphold certificate conditions imposed by the Commission: *Atlantic Refining Company v. PSC*, 360 U.S. 378 (1959); *Transcontinental Gas Pipeline Co. v. FERC*, 589 F.2d 186, 190 (5th Cir. 1979), *cert. denied*, 445, U.S. 915 (1980) (conditioning of certificates to ensure appropriate allocation of risk); and *Alabama-Tennessee Natural Gas Co. v. FPC*, 203 F.2d 494 (3rd Cir. 1953) (imposition of rate conditions).

The main argument of the commenters that oppose the non-discriminatory access provision is that the condition would, in effect, subject interstate and intrastate pipelines to regulation as common carriers. According to these commenters, while participation in the self-implementing program may be voluntary, participation for all practical purposes is mandatory because pipelines will be forced by economic and competitive necessity to participate in the program in order to remain financially viable. Others argue that the non-discriminatory access provision could have the effect of imposing increased costs on customers, such as take-or-pay costs when transportation displaces sales.

Furthermore, these commenters argue that the Commission does not have legal authority to apply the condi-

tion to either certificates issued under section 7 of the NGA or self-implementing transportation authorized under section 311 of the NGPA.

Several of the commenters point to the legislative history of the NGA in support of their view that the Commission is abusing its section 7 conditioning authority in attempting to do indirectly that which Congress has expressly declined to give the Commission authority to do directly, i.e., make pipelines common carriers. These commenters point to the express ommission of common carrier authority in the legislative history of both the NGA and NGPA, as well as several legislative proposals to impose non-discriminatory access or express common carrier requirements on natural gas pipelines which have been introduced in Congress but not enacted since enactment of the NGA.

For example, Panhandle Eastern Pipe Line notes that there has been but one exception to what it perceives as Congress' long-standing reluctance to legislate common carriage by natural gas pipelines. That exception is the requirement in the Outer Continental Shelf Lands Act of 1978, 42 U.S. 1334(e) and (f), that natural gas pipelines to which the Secretary of the Interior has granted authority to transport Outer Continental Shelf (OCS) gas must provide transportation on a non-discriminatory basis. Panhandle reasons that the absence of a similar provision in the NGA or NGPA demonstrates that Congress concluded that the Commission should not have the authority to require that pipelines authorized to transport natural gas under those Acts do so in a non-discriminatory manner.

Intrastate pipelines and their state regulatory bodies assert that the access condition is an unsupportable attempt to pre-empt state regulation of intrastate activities.

Commission Response. In considering those comments that suggest the Commission lacks legal authority to

apply the non-discriminatory access condition to interstate transportation under the NGA, the Commission has reviewed the requirements of the NGA, including legislative history and relevant case law.

Section 7(e) of the NGA states, in pertinent part, that:

> The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

According to the Supreme Court:

> The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges . . .
>
> . . . In view of this framework in which the Commission is authorized and directed to act, the initial certification of a proposal under § 7(e) of the Act as being required by the public convenience and necessity becomes crucial. This is true because the delay incident to determination in § 5 proceedings through which initial certificated rates are reviewable appears high interminable.

Thus, the Commission's certificate and conditioning authority is the means by which it effectuates the purpose of the NGA to underwrite just and reasonable rates to the consumers of natural gas. Any attack on a condition in a certificate issued by the Commission must confront the well-established principle that generally the Commission has extremely broad authority to condition certificates of public convenience and necessity.

This broad conditioning authority must be examined in the context of Congress' consideration of the NGA itself. It is abundantly clear from the history of the Act and from the events that prompted its adoption that Con-

gress considered the natural gas industry to be heavily concentrated and that monopolistic forces were determining the amount of natural gas that could be marketed by fixing the amount that could be transported.

Thus, section 7(e) of the NGA gives the Commission the power to attach conditions to certificates where required by the public convenience and necessity.

Beyond section 7, however, sections 4 and 5 of the NGA also prohibit unduly discriminatory or preferential practices by natural gas companies. The Commission has determined that the practice of restricting access to transportation is unduly discriminatory and preferential; and, importantly, has prevented consumers from obtaining the lowest reasonable rates for both transmission services and gas costs. Therefore the Commission intends the final rule to be an exercise of its conditioning authority to effectuate the non-discrimination requirements of the Act and to insure that consumers will obtain gas and transportation at just and reasonable rates.

Given the breadth of our section 7 conditioning authority and our obligation under sections 4 and 5, we must ask whether the proposed non-discriminatory access condition is so broad as to impose, either directly or indirectly, common carrier obligations on pipelines in violation of the NGA.

Notwithstanding the basis of the condition in sections 4, 5 and 7 of the NGA, several commenters have asserted that Congress failed to enact amendments to the NGA which would have imposed mandatory transportation requirements on natural gas pipelines, and therefore the NGA by implication does not authorize the Commission to impose common carrier status on pipelines.

Of key interest to the Commission in its review of the legislative history are sections 303 and 304 of Title III of H.R. 5423 introduced in 1935 by Representative Sam

Rayburn, Chairman of the House Committee on Interstate and Foreign Commerce.

Sections 303 and 304 of H.R. 5423 provided in pertinent part (emphasis added):

> Section 303(a). *It shall be the duty of every distributor to* furnish natural gas, to exchange natural gas with, and *transmit natural gas for any person* upon reasonable request therefor; and to furnish and maintain such services and facilities as shall promote the safety, comfort and conveniences of all its customers, employees, and the public, and shall be in all respects adequate, efficient and reasonable . . .
>
> Section 304. Whenever the Commission after notice and opportunity for hearing finds such action necessary or desirable in the public interest, *it may by order direct a distributor* to make additions, extensions, repairs, or improvements to or changes in its facilities, to establish physical connection with the facilities of one or more persons, to permit those of its facilities by one or more persons, or utilize the facilities of, sell natural gas to, purchase natural gas from, *transmit natural gas for*, or exchange natural gas with *one or more other persons* . . . [T]he Commission may prescribe the terms and conditions of the arrangement to be made between such persons, including the apportionment of reimbursement reasonably due to any of them.

If these sections would have imposed common carrier obligations on natural gas pipelines, and therefore were rejected by Congress, a principal attribute of common carrier status must be its *mandatory* nature. Thus, section 303 would have imposed an affirmative "duty" on pipelines to "transmit" natural gas "for any person." Section 304 would have provided the Commission with the concomitant authority to "by order direct" any pipeline to "transmit natural gas for . . . one or more other persons. . . ."

Sections 303 and 304 must be read in the context of sections 4(b) and 5(a) of the NGA as enacted. In contrast to proposed section 303's affirmative duty, section 4(b) flatly prohibits "any undue preference or advantage" and "any reasonable difference" in service or as between classes of service. In contrast to proposed section 304's discretion to *order* transportation, section 5(a) contains *no express authority to order transportation.* Instead, section 5 permits the Commission to find that "any rule, regulation, practice or contract" affecting transportation rates, charges or classifications is ". . . unduly discriminatory, or preferential" and thereafter fix prospectively by order the "just and reasonable . . . rule, regulation, practice or contract" to be observed.

On the one hand, sections 303 and 304 would have imposed an affirmative duty on pipelines to transport for others and backed up that duty with discretionary authority on the part of the Commission to order such transportation.

On the other hand, sections 4, 5, and 7 of the NGA attach non-discrimination obligations to the "practices" of pipelines and back up those obligations with broad conditioning authority on the part of the Commission. But the Natural Gas Act does not expressly *require* pipelines to transport for others as an affirmative duty.

We have considered whether the nondiscriminatory access condition in the final rule amounts to a "direction" or a "mandate" to pipelines to transport for others as an "affirmative duty." First, the condition is just that: A *condition* on the certification or authorization of certain self-implementing transportation services which a pipeline may *voluntarily choose to perform or not*, strictly at its own option. Thus, it does not "direct" or "mandate" a pipeline to do anything. Second, the condition, even when accepted by a pipeline as part of its self-implementing transportation program, does not impose any "affirmative duty" on a pipeline to transport. It

only requires that when a pipeline *does* choose to transport on a self-implementing basis, it must provide those transportation services in a nondiscriminatory manner. Nor does the condition cover all transportation services and thus operate as mandatory *in effect.* A pipeline remains free to seek authorization for other transportation programs not covered by the condition and the Commission will review them on a case-by-case basis.

In addition, the condition expressly applies, verbatim, the statutory prohibitions on unduly discriminatory or preferential practices, rates or charges imposed by Congress when it enacted sections 4 and 5 of the NGA.

The Commission need not decide in this rulemaking whether it may ever order transportation on a mandatory basis. The Commission plainly has broad powers to enforce the congressional directives and these powers are at their height when the Commission is fashioning a remedy for a violation of the statute or an existing regulation. *Niagara Mohawk Power Co. v. FPC,* 379 F.2d 153, 159 (D.C. Cir. 1967). But while these powers may be available in appropriate cases, there is no need to test their scope here, where the regulatory obligations are voluntarily assumed. Further the condition only applies with regard to each of the individual types of transportation service offered and does not cover transportation under existing individual section 7 certificates or new individual section 7 certificates filed outside of the optional expedited certificate procedure.

Judicial recognition of the Commission's authority to impose the non-discriminatory access condition has already been indicated in the companion cases *Maryland Peoples Counsel v. FERC,* Nos. 84-1019 and 84-1090 (D.C. Cir. 1985). In those cases, the court vacated Columbia Transmission Company's special marketing program and the Commission's rule allowing pipeline transportation for certain industrial end-users. In both instances, the court found the Commission had not justified

the programs to the extent they allowed pipelines to transport gas to some customers without requiring pipelines to furnish the same service to all customers on non-discriminatory terms.

In its order on the blanket certificate program (No. 84-1090), the court noted, *id.* at n.19, that MPC's plea that blanket transportation certificates be conditioned on non-discriminatory access records with the recommendation of the Department of Energy: "To achieve the benefits of a properly developed spot market for natural gas . . . FERC should use its authority over natural gas transportation to require pipeline companies to provide carriage on a non-discriminatory basis whenever there is idle pipeline capacity." DOE Report, *supra* p. 3, at 82. The court further noted that the Commission does not question that it has such authority, *citing Tennessee Gas Pipeline Co. v. FERC*, 689 F.2d 212, 214-15 (D.C. Cir. 1982); *Transcontinental Gas Pipe Line Corp. v. FERC*, 589 F.2d 186, 190 (5th Cir. 1979) (invoking "the well-established principle that generally the Commission has extremely broad authority to condition certificates of public convenience and necessity"), *cert. denied*, 445 U.S. 915 (1980).

Finally, we view section 311(c) of the NGPA as conferring sufficient authority to require a comparable condition under transactions authorized under that statute. The effect of NGPA section 602(b) is discussed below.

b. Authority To Impose on Interstate Transportation by Intrastate Pipelines

Comments. Interstate pipelines and state regulatory commissions cite the NGPA section 602(b) prohibition on common carrier status for section 311 transporters as an absolute ban on application of the non-discriminatory access condition to their operations. They also state that the condition is illegal under NGPA section 601(a)(2)(A), which exempts transportation by intrastate pipe-

lines under section 311(a) of the NGPA from Commission jurisdiction for purposes of section 1(b) of the NGA.

These intrastate pipelines perceive the access conditions as a back door through which the Commission may intrude on their non-section 311, purely intrastate activities. They fear that the non-discriminatory access requirements ultimately will result, if they agree on any section 311 transportation, in more and more of their capacity being obligated to section 311 transportation. Consequently, they assert, the capacity available for intrastate activities would diminish, threatening their viability in the intrastate market. Further, the rate charged by a pipeline in each new section 311 transportation arrangement would be subject to regulation by the Commission under the proposed rule. Therefore, intrastate pipelines, as well as many state regulatory agencies, view the non-discriminatory access condition as an indirect but substantial threat by the Commission to preempt state authority over intrastate pipeline activities. These commenters argue that the non-discriminatory access provision, therefore, violates NGPA sections 601(a)(2)(A) and 602(b).

Commission Response. The Commission has absolutely no intention of regulating *intrastate* transportation of natural gas. Rather, the intent of the proposed rule was simply that the same non-discriminatory access condition should apply to all transportation in interstate commerce, whether by an entity subject to FERC jurisdiction under the NGA or to other entities allowed by the Commission under the NGPA to engage in such interstate commerce without becoming subject to the NGA.

Several changes have been made in the final rule to clarify this intent. First, there is no requirement that intrastate pipelines under section 311 provide such transportation service on a firm basis. See § 284.8(a)(2). Firm transportation is not prohibited, however. In the

event an intrastate pipeline offers firm transportation then § 284.8(b) requires that it provide "such" service on a non-discriminatory basis.

Similarly, if an intrastate pipeline offers interruptible interstate transportation (under § 284.8(a)(ii)), the only obligation is to provide "such" interruptible service on a non-discriminatory basis. See § 284.9(b).

Thus, the final rule completely avoids the situation whereby in intrastate pipeline is required to offer firm service for out-of-state shippers, thus, progressively being turned into an interstate pipeline against its will and against the will of the responsible state authorities.

With regard to the rate conditions of § 284.7, the proposed rule would have required intrastate pipelines to comply with the same conditions. The final rule makes it clear that the rate conditions of § 284.7 apply only to transportation under Subparts B, G and H and not to transportation by intrastate pipelines under Subpart C. The final rule retains the pre-existing rules regarding rates for Subpart C transportation. See section 284.123. In essence, there have been no real concerns with transportation by intrastate pipelines and therefore there is no need to modify the current rules.

With regard to the comment that the non-discriminatory access condition violates section 602(b), we note that the NGPA does not define "common carrier." Section 602(b) has scant legislative history. The only mention of the purpose of section 602(b) in the Conference Agreement merely states that the House bill had provided that "the intrastate pipeline would not have been subjected to regulation as a common carrier. . . ." The Commission notes that Congress did not directly authorize section 311 transportation but gave the Commission the discretion to authorize such transportation under such terms and conditions as the Commission might prescribe under sections 311(c) and 501(a) of the NGPA.

All the Commission is doing here is ensuring that where a new entity enters into the field of offering interstate transportation services, that it do so on a non-discriminatory basis. We cannot accept the premise that section 602 (b) is a Congressional license to "intrastate pipelines" to enter into the field of interstate commerce on an avowedly discriminatory basis. Whatever else the prohibition regarding "common carrier" status may do, it does not sweep so broadly as to license unduly discrimintory rates or practices. The same conclusion applies to interstate pipelines operating under section 311.

Further, it appears from the legislative history of the NGPA that the Commission's conditioning authority under NGPA sections 311(c) and 501(a) is coextensive with the broad discretion granted to the Commission under section 7(c) of the NGA. Section 311(c) must be read in light of the fundamental intention of the NGPA to facilitate the movement of gas between the intrastate and interstate markets following a period of severe curtailment of interstate supplies coincident with ample intrastate supplies.

Hence, the Commission has determined that the nondiscriminatory access condition does not violate section 602(b).

The Commission emphasizes that it fully respects the bounds of its jurisdiction under section 1(b) of the NGA as reaffirmed by section 601(a)(2)(A) of the NGPA. The Commission does not intend that any aspect of the final rule intrude in any way whatsoever on the sound discretion of the states to regulate strictly intrastate transactions in the public interest. Nor does the Commission intend the final rule in any way whatsoever to impair the ability of intrastate pipelines to provide reliable service to their intrastate customers.

3. *The reasonableness of the non-discriminatory access condition.*

Comments. Some commenters complain that the non-discriminatory access condition is unreasonable, and therefore not authorized under law or otherwise appropriate, because it would interfere with pipelines' ability to make necessary and appropriate business decisions such as choosing a product/market mix of transportation and sales services, or declining to provide transportation services that would impair their ability to meet their obligations to existing sales customers. Intrastate pipelines state that the non-discriminatory access condition could potentially affect their ability to provide services in the intrastate market. Several commenters suggest that the harm to the reliability of existing services to pipeline customers would outweigh the benefits of the non-discriminatory access condition to new transportation customers.

Some industrial end-users state that the imposition of the non-discriminatory access requirement on intrastate pipelines is unreasonable because most state agencies already have authority with respect to intrastate pipelines to accomplish the Commission's goal in proposing the condition. These commenters point to New Mexico and other states that have enacted or are considering statutes that require non-discriminatory gas transportation.

One industrial end-user, Air Products, argues that the Commission's proposal to apply the non-discriminatory access provision to intrastate pipelines would diminish the interstate-intrastate pipeline integration achieved since enactment of the NGPA. Lack of system integration would hinder the ability of interstate pipelines and their customers to gain access to reserves connected to intrastate pipelines. Accordingly to Air Products, the undesirable effects would result because intrastate pipelines would rather forego NGPA sections 311 transporta-

tion altogether than expose all of their intrastate operations to possible Commission jurisdiction.

Other commenters, such as Oklahoma Natural Gas Company, suggest that the Commission revise the proposals to specifically limit application of the non-discrimination and firm transportation requirements to an intrastate pipeline's excess capacity in order to reassure intrastate pipelines and state regulatory agencies that the Commission will not intrude on local activities beyond its jurisdiction.

On the other hand, commenters supporting the non-discriminatory access condition assert that the condition is reasonable and absolutely necessary in order to ensure access, by pipeline customers and other shippers, to competitive priced gas supplies at the wellhead. They point to the proliferation of individual pipeline transportation programs and the expanded flexibility of the program proposed by the rule as direct benefits to pipelines which agree to the non-discriminatory access condition. Finally, they point to the history of pipeline gas purchasing practices over the last 30 years as justification for requiring pipelines who transport for others to do so on a non-discriminatory basis for all consumers.

Commisison Response. With regard to *intrastate* pipelines, we repeat what was stated above: intrastate pipelines are under no requirement to offer firm service under Subpart C, and the non-discriminatory access condition will apply only to the intrastate pipeline which provides "such" interruptible or firm service. Thus, where an intrastate pipeline offers only interruptible service, the access condition can in no way adversely affect its ability to provide firm service to intrastate customers.

With regard to *interstate* pipelines, the condition is also reasonable. First, the actual condition is voluntary. There is no requirement under the statutes or the rules that an interstate pipeline provide transportation under

the self-implementing regulations. Moreover, the condition imposes, verbatim, the statutory ban against undue discrimination. The access condition, therefore, must be included in certificates and self-implementing transportation agreements in order to assure that gas supplies and transmission services are provided as broadly as possible in response to new demands from consumers and new competition in gas markets.

In addition, the final rule expressly recognizes in §§ 284.8(c) and 284.9(c) the need for reasonable operational flexibility. Finally, the condition is imposed in the context of a rate structure under §§ 284.7 and 284.8(d) which fully contemplates self-implementing transportation. Costs will be properly allocated among services to be offered; unit rates will be designed; and the pipeline will have a reasonable opportunity to recover its prudently incurred costs by providing services for its customers. This is the core of utility ratemaking.

Thus, the access and rate conditions *prohibit* a regulated pipeline from engaging in unduly discriminatory or preferential behavior and *provide* a rate structure under which the pipeline may earn its allowed return without engaging in such behavior. To assert that such a condition is unreasonable is simply not credible.

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[50 Fed. Reg. 42433-34]

5. *Availability of access to persons outside NGA jurisdiction.—a. Condition distributor access to interstate transportation on requirement that they provide transportation to retail markets.*

Comments. Several commenters suggested that nondiscriminatory access to transportation should be available to an LDC only as a reciprocal condition on the distributor providing access through its own facilities to self-implementing transportation services under the final rule.

Commission response. The Commission declines to condition distributor access in this manner.

An argument could be made that such a condition on a non-jurisdictional entity is beyond the scope of the Commission's jurisdiction. But while we note this argument, we do not rely upon it for our ruling here. See *FPC* v. *Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1 (1961) (the Transco "X-20" case) (holding that the FPC had authority to deny a transportation certificate based on the end-use of the gas at retail).

Rather, our decision is based on the fact that such a condition would bring the Commission into direct conflict with responsible state authorities. For example, as detailed above, a number of states have adopted statutes or regulations dealing with trarsportation services by local distribution companies. In other states the issue remains under review. A federal requirement that distributors provide a certain type of transportation service as a condition to obtaining interstate transportation could put the distributor under conflicting federal and state obligations. Thus, it is not a case where the Commission might veto on federal grounds a transaction which state public utility commissions might favor as a matter of state policy. Rather, the proposed condition would essentially mandate on federal grounds a transaction that a state may wish to forbid or to structure in a different manner.

Moreover, as noted above, questions of cost allocation and rates are intimately tied into the issue of the reasonableness of a transportation obligation. Yet we wholly lack jurisdiction over the rates of local distribution companies.

Indeed it was for the express purposes of avoiding such federal-state conflicts that Congress adopted section 1(c) (the "Hinshaw Amendment") of the NGA in 1953. The legislative history of the Hinshaw Amendment makes it

clear that it was enacted to essentially overturn a Supreme Court decision (*FPC* v. *East Ohio Gas Co.*, 338 U.S. 464 (1950)), that had interpreted the NGA to allow FPC regulation over local distribution companies. See Rep. No. 817, 83d Cong., 1st Sess. 2102 (1953). Since the proposed access condition on distributors would put us in the business of regulating rates and practices of the distributors in order to enforce the conditions, it would bring about exactly the kind of conflict the Congress intended to avoid. Accordingly, we decline to adopt it.

b. *Condition producer access to interstate transportation on requirement that they waive contractual rights under take-or-pay provisions*

Comments. Just as some commenters argued for conditioning distributor access, so at the other end of the pipeline, many (but not all) interstate pipelines urge the Commission to condition access by producers. These commenters assert that the Commission has the authority to require producers to waive contractual rights under the take-or-pay provisions of existing contracts as a condition to obtaining non-discriminatory transportation. They further assert that the exercise of such authority is reasonable to enhance the pipelines' bargaining leverage in renegotiating contracts with producers.

Commission Response. As with the request to restrict access to non-discriminatory transportation at the distribution end of the pipeline, so the Commission declines to restrict access to only certain producers. If transportation is to be available to the public on an equal and non-discriminatory basis, we cannot allow some shippers to be "more equal" than others.

In addition, for gas that has been removed from the Commission's NGA jurisdiction, there is a serious question as to whether the Commission has the authority to require a non-jurisdictional party to give up a valid contractual right as a condition to obtaining service. At the

August hearing, a number of pipeline representatives expressed the opinion that such a course of action was a "close question," or one to which a "definitive answer" could not be given.

This uncertainty is reinforced by the court cases defining the limits of the Commission authority over natural gas production. *See e.g., Shell Oil Co. v. FPC*, 566 F.2d 536 (5th Cir. 1978) (reversing FPC Policy Statement regarding "prudent operator" standard), and *Pennzoil v. FERC*, 645 F.2d 360, 380-82 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982) (holding that FERC lacks the power to even interpret gas purchase agreements between producers and pipelines for the sale of gas which has been removed from NGA jurisdiction).

It is one thing for the Commission to exercise its conditioning authority over regulated natural-gas companies to require them to provide access to shippers on a nondiscriminatory basis. It is quite another to *deny* access to some shippers unless they agree to take action which is beyond our power to compel.

We also note that some pipelines continue to make progress in renegotiating their contracts with producers while others have been able to renegotiate much of their take-or-pay exposure, particularly for past periods. For example, while the potential take-or-pay liability for pipelines as a group has been estimated at $7-10 billion, actual prepayments in rate base have been far smaller. See Exhibit O. Moreover, actual prepayments in rate base in July of 1985 were over $100 million *lower* than in December of 1982. (Exhibit O.)

In addition, as noted in Table C-1, over $470 million in take-or-pay liability has been bought out for about $80 million in amounts sought to be recovered through filings with the Commission. We also note the repeated statements in the comments that negotiations remain active in this area and that the Commission's proposed "safe

harbor" rule has slowed that process rather than encouraging it. It is mainly for this reason that we have determined not to promulgate rules relating to such buy-outs.

Accordingly, under these circumstances and given the fact that conditioning access would run completely counter to the whole idea of opening up the transmission grid on a non-discriminatory basis, the Commission declines to condition producer access as suggested.

6. *Withdrawal of a pipeline from self-implementing transportation.*

Comments. Some interstate and intrastate pipelines request that the final rule permit them to discontinue or abandon their self-implementing transportation authority in the future as a matter of sound business judgment and therefore avoid the non-discriminatory access condition on all subsequent individual transportation transactions.

Other commenters, notably industrial end-users, urge the Commission to assure that pipelines do not use any "pre-grant" of abandonment authority for self-implementing transportation as a means of discriminating against shippers by moving "in and out" of a self-implementing transportation program initiated under the rule.

Commission Response. The Commission intends the self-implementing transportation authority in the final rule to provide incentives for pipelines to accept a conditioned certificate and to make use of Part 284 authorization. However, a pipeline's decision to do so is not irrevocable. The Commission does not intend to foreclose a pipeline from making a business decision to discontinue self-implementing transportation in the future and thus resume its status as a "merchant," only.

The rules governing a request to terminate all service under a Subpart G blanket certificate are the same basic

rules as apply whenever a pipeline seeks to discontinue a particular service. See 18 CFR 157.18. The Commission would review these requests on a case-by-case basis exactly as it does under the existing regulations.

With regard to transportation under Subparts B and C, the Commission declines to promulgate regulations addressing termination of service. These services are not subject to section 7(b) of the NGA and we decline to impose comparable procedures by way of a condition issued under NGPA section 311(c). Instead, the Commission will view termination of service under Subparts B and C as subject to the non-discrimination condition. For example, a decision by an intrastate pipeline to cease providing interruptible service that it has been providing under Subpart C must be non-discriminatory. In other words, the decision to terminate transportation cannot be a subterfuge to avoid the regulations. But a bona fide decision to cease providing any self-implementing transportation would be non-discriminatory.

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[50 Fed. Reg. 42434-35]

7. *Enforcement of the access conditions.*

Comments. Many producer and end-user commenters, while lauding the purpose behind the non-discriminatory access condition, nonetheless expressed doubts that its benefits would be realized without more specificity in the final rule as to what constitutes preference or undue discrimination, and how the generic standard will be enforced by the Commission on a case-by-case basis.

Commission Response. As indicated above, the Commission believes that the changes in the ratemaking structure (and the tools for addressing take-or-pay obligations), once fully implemented, should avoid any need for an extensive policing mechanism. But we recognize that there may still be instances, especially initially and espe-

cially involving transactions between affiliates, where complaints of undue discrimination may be made.

Accordingly, the Commission believes it may be helpful to provide some guidance as to the types of conduct that we consider to be unreasonable and undue under the new rules.

First, it should be stressed that the Commission intends the non-discriminatory access condition imposed in this rule to be construed broadly as a first line of defense against arbitrary or exclusionary transportation practices. For example, the Commission finds that a refusal by a pipeline to transport gas in competition with its own sales services, is unduly discriminatory or preferential and in violation of the non-discriminatory access condition.

As another example, the Commission finds that transportation tariffs, terms and conditions, including but not limited to prices, minimum volume or operational requirements, or schedules, that are designed to favor pipeline affiliates over non-affiliated shippers are preferential or unduly discriminatory practices under this rule.

Similarly, the Commission finds that arrangements by pipelines that tie or "bundle" gathering, production, storage, or other services not requested by shippers to self-implementing transportation service offered under this rule would constitute undue discrimination in violation of the non-discriminatory access condition (and probably the rate conditions, as well), if the costs of such services are not properly allocable to a fully-allocated transportation rate.

In addition, § 284.12 of the final rule includes a requirement that all pipelines operating under the new rules make yearly filings showing the estimated peak day capacity of the system under reasonably representative operating assumptions. The Commission recognizes that pipeline capacity is not a single, fixed quantity, but some-

thing that varies according to time and operating conditions. Thus, the purpose of this finding is not to establish pipeline capacity, but to allow the pipeline, itself, to determine its total capacity and to submit that determination for public review.

Finally, we note that the Commission, in setting projected levels of transportation in individual rate cases, may include the express consideration of whether complaints of undue discrimination or preference have been made concerning a pipeline's transportation practices. For example, if it is determined that a pipeline has capacity available for transportation in excess of its filed for projected levels, the Commission may take into account verified complaints that such capacity is being withheld on a discriminatory basis or is being under-utilized, and set higher projected levels as a disincentive to such discrimination or under-utilization. The Commission could also disallow the inclusion in rate base of unused assets.

Comments. Some commenters request assurances that there will be a mechanism that will permit reliable determinations as to whether pipelines are in fact providing transportation on a non-discriminatory basis. In this regard, some commenters recommend that each pipeline be required to file monthly reports listing all persons who requested transportation service during the prior month, the volumes for which transportation was requested and whether the pipeline agreed to transport and, if so, the volumes it agreed to transport.

Commission Response. The Commission recognizes the importance of ensuring that it be made aware of pipelines that are not complying with the non-discriminatory access condition. As noted above, the rate structures for self-implementing transportation, once fully implemented, help minimize the need for a special enforcement procedure. However, the Commission notes that shippers that believe they have been refused service in a discrimina-

tory manner may, and can be expected to, apprise the Commission of that allegation. Such complaints may be reviewed on an expedited basis and further appropriate action taken. In addition, as noted above, a new § 284.12 has been included in the final rule requiring an annual filing by the pipeline regarding its total capacity. This filing should assist disappointed shippers in determining whether filing of a complaint may be appropriate or not.

The Commission has determined not to extend the nondiscriminatory access condition on a generic basis to all section 7 transportation certificates at this time. The Commission does not consider undue discrimination or preference any more acceptable under individual section 7 transportation or sales certificates than under self-implementing transportation authority. However, individual section 7 transportation arrangements can be scrutinized in advance by the Commission on a case-by-case basis when they are applied for; whereas, self-implementing transportation authority permits such arrangements to proceed on a "blanket" or generic basis.

For this reason, the Commission will continue to review individual section 7 certificates on a case-by-case basis to determine whether they should or should not be subject to an express (as opposed to the statutory) nondiscriminatory access condition.

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[50 Fed. Reg. 42462-65]

B. Take-or-Pay Buy-Outs and Producer Abandonment

1. *Overview.* In Part B of the NOPR, the Commission proposed to offer pipelines a rebuttable "safe harbor" presumption of prudence for certain one-time payments made to extinguish all minimum payment or purchase obligations in certain qualifying contracts. The proposal was intended to help pipelines address take-or-pay obligations in so-called "problem contracts." The Commission

proposed that this method of handling take-or-pay payments be available only to pipelines that offer transportation on a non-discriminatory basis. The Commission proposed definitions of qualifying contracts and payments, accounting and cost recovery procedures, and filing requirements. The Commission also proposed to amend § 2.76 of its regulations, which called for a case-by-case resolution of recovery of take-or-pay payments.

The majority of commenters express great dissatisfaction with or reservations about the safe harbor presumption. Very few express support without proposing some modification. Many commenters object to the overall theory of the proposal as well as to its specific requirements. We are persuaded that an attempt to impose a regulatory solution at this time may actually aggravate the situation rather than improve it. Accordingly, we are persuaded by the comments that the prudent approach regarding take-or-pay buyouts is to retain the April 10, 1985 Statement of Policy and Interpretive Rule. We have also determined to establish additional procedural rules to be codified in a new § 2.77 to provide for expedited consideration of producer abandonment applications under the present substantive criteria.

2. *Summary of comments.*—a. General. The interstate pipelines generally believe the proposal is unworkable or inadequate, or will exacerbate the take-or-pay situation. They say financing these amounts will be difficult, and together with denial of carrying costs or return, pipelines' income will be affected. Pipelines point out that they have substantial take-or-pay exposure under large numbers of contracts, and it is doubtful that producers will agree to a buy-out of such large obligations for a modest percentage. Many pipelines believe it is likely that producers will hold out for the maximum obtainable in qualifying payments, thereby leaving large liabilities under remaining qualifying contracts to be recovered on a case-by-case basis anyway.

Various producers state the proposal will cause problems with, *inter alia*, financing, cash flow, drainage, cancellation of leases should wells not produce in "paying quantities", state proration requirements, and royalty payments. Several producers argue that without take-or-pay provisions, gas wells become, in effect, gas storage fields for pipelines. The producer cannot sell the gas since the pipeline holds the contract right to it, yet the pipeline has no obligation to take gas. According to one producer, the proposal is bad for producers as they receive some unknown percentage of a speculative unrecoupable obligation covering only two years of a contract.

Distributors and customers were also generally lukewarm about the proposal, expressing opinions ranging from flat opposition to any safe harbor arrangement, to urging the Commission to encourage existing negotiation. A distributor association believes the rule will probably increase total take-or-pay liabilities, and the proposed safe harbor formula will encourage producers to demand greater buy-out amounts.

According to one state commission, the Commission has not demonstrated either that a "safe harbor" is needed or that it will not cause more problems than it cures. The state commission says pipelines are now renegotiating take-or-pay, often for pennies on the dollar, and, by presuming prudent set percentages, the Commission may actually raise buy-out costs and hinder the restructuring of the industry.

Another state commission references an offer of settlement made by Northern Natural Gas Company, a Division of HNG-InterNorth, in which Northern proposed a permanent tariff permitting any distributor on its system to convert sales into transportaton service. The state commission notes that Northern's proposal is not conditioned on the availability of safe harbor or other NOPR incentives, the costs of which would be borne primarily

by a pipeline's captive customers. It believes the simple fact that the proposal exists demonstrates that the NOPR incentives are unnecessary.

Some commenters believe that the current negotiation process, market forces or both are sufficient to resolve the take-or-pay problem. The Department of Energy fears the safe harbor rule may be so mechanical as to distort ongoing and future negotiations and to undermine the efficient operation of market forces.

Many of the comments reflect the view that present procedures are working to realign contract rights and obligations. Commenters from a broad spectrum of the industry assert that the present system of renegotiating take-or-pay provisions under the guidelines of the April 10, 1985 Statement of Policy is working well, and that the Commission should encourage this process. A strong reaffirmation of the Policy Statement is recommended by several commenters.

b. Legal Authority and Applicability of the Presumption

A few commenters address the Commission's legal authority to establish such a presumption. Several commenters point out that under section 4 of the NGA pipelines have the burden of proving their rates to be just and reasonable. Consequently, the safe harbor presumption conflicts with this stautory standard. One commenter says that it discerns no rational reason for a presumption that qualifying lump-sum payments would be deemed prudent. It urges that the Commission require pipelines to meet the traditional just and reasonable standard and shoulder the burden of proof.

The Commission proposed that the safe harbor presumption apply to future payment or purchase obligations. However, the Commission recognized that past and/or current take-or-pay prepayments may affect a pipeline's current and future business decisions. The

Commission specifically requested comments on whether the safe harbor presumption should be expanded to include previously incurred and outstanding liabilities.

Many commenters suggest, if there is to be a safe harbor presumption, the Commission should expand it for additional categories of take-or-pay obligations. A number of commenters advocate extending the presumption as the Commission proposed, with the same percentage level for qualifying payments.

Several commenters propose that neither the safe harbor presumption nor amortization of take-or-pay payments apply to any payments made by a pipeline to its production division/affiliate. They suggest the pipelines should have the burden to prove the prudence of payments to affiliates, or, payments to affiliates could be limited to the average of all other supplier payments. One distributor asserts there is no rational basis for permitting a pipeline to charge the consuming public for this buy-out of a contract it negotiated with itself.

c. Requirement That all Obligations be Extinguished

Many commenters object to the requirement that payments must extinguish *all* obligations under a contract. "Onerous," "extreme," and "unworkable" are but a few of the terms used to describe this requirement. They request the Commission to consider extending the presumption to *buy-downs*, i.e., partial extinguishment, of take-or-pay obligations. Several suggest the safe harbor presumption apply to payments which lower the take-or-pay level to at least 50%. They note that take-or-pay provisions play a role in a producer's financing of its operations, maintaining of lease rights, royalty payments, etc.

Producers were especially reluctant to give up all take-or-pay. A major producer group suggests that contract provisions which set the maximum percentage of deliverability as the minimum contract quantity, e.g., the 75

percent prescribed in the 1982 Policy Statement, be eligible for the safe harbor presumption.

d. Requirement That Pipelines Offer Transportation

The Commission proposed that the safe harbor presumption be available only to those pipelines that agree to offer transportation services on a non-discriminatory basis as discussed in Parts A and C of the NOPR. Relatively few persons commented on this aspect of the NOPR.

A coalition of industrial users fully supports the condition and says the safe harbor presumption should be reserved solely for such pipelines. A major producer, however, argues that the presumption should not be limited just to those pipelines which choose to be transporters, and that it would be discriminatory to differentiate among pipelines for purposes of take-or-pay settlements. A major pipeline also believes the measure should be available to *all* gas purchasers, not simply those pipelines which are willing to accept consequences such as giving up their contract demand rights.

e. Qualifying Contracts

Only certain first sales contracts—"qualifying contracts"—were eligible for the safe harbor presumption under the proposed rule. In § 161.2(a), the Commission defined "qualifying contract" as:

> A contract for a first sale of natural gas entered into before January 1, 1982, the primary term of which will continue beyond January 1, 1986.

A significant number of commenters address the cut-off date for determining qualifying contracts. Many support the Commission's proposed January 1, 1982 date.

Several commenters propose that all first sales contracts entered into prior to the effective date of this final

rule should be deemed qualifying contracts. Others suggests [*sic*] May 30, 1985, the date of the notice issued.

f. Minimum Purchase of Payment Obligation

In proposed § 161.2(b), the Commission defined "minimum payment or purchase obligation" as the mathematical product of:

> (1) The minimum take-or-pay quantities specified in a qualifying contract for the time period remaining in the primary term of such contract after January 1, 1986, multiplied by
>
> (2) The contract price for such quantities.

Many commenters believe calculation of the minimum payment or purchase obligation will be difficult, if not impossible. Several point out that many natural gas contracts do not specify a minimum take in terms of fixed volume of gas, but provide for a yearly calculation of take based on well deliverability.

g. 1986-1987 Unrecoupable Obligation

The Commission defined "1986-1987 unrecoupable obligation" as those minimum payment or purchase obligations of a pipeline which are reasonably estimated to (1) obtain under all of a pipeline's qualifying contracts for a two-year period commencing January 1, 1986 and (2) not be recouped under the terms of the contract.

Many commenters complain that this term is not adequately defined. A producer states the arbitrary two-year period is not representative of the remaining years in gas purchase contracts in any event. Many commenters point out that calculating the amount likely to be unrecoupable will be difficult since no one knows now the extent of reductions in contract demand.

h. Qualifying Payments

The Commission proposed to set certain percentage limitations on the amount of payments that may be deemed prudent. For qualifying contracts with a primary term remaining of five years or less on December 31, 1985, the Commission proposed that total qualifying payments be no more than X percent of a pipeline's total 1986-1987 unrecoupable obligation. For qualifying contracts with a primary term of more than five years, the Commission proposed Y percent. The Commission specifically requested comments on what the X and Y percentages should be.

Approximately half of the commenters on this issue set forth, in differing levels of detail, specific proposals on the qualifying payments formula. The proposals range from 0 to 50 percent. A sub-group of these commenters disagrees with the Commission and argues that a single X percent, rather than X and Y, should be used for ease of administration of the rule. Another small group of commenters on this issue recommends that the Commission undertake further procedures (*e.g.*, a supplemental rulemaking devoted to the development of the X and Y percentages, or an analysis of all pipelines' expected unrecoupable obligations). Another group of roughly half the commenters on this issue, predominantly pipelines, argues that no fair percentages for X and Y could be set.

The majority of commenters assert that these percentages, while intended to be ceilings, would quickly become floors in the negotiations with producers. Several commenters recall that NGPA Title I "maximum" lawful prices quickly became the uniform prices.

i. Allocation of Qualifying Payments

The Commission requested comments on how the costs of the qualifying payments should be allocated. The ma-

jority of commenters appear to favor some sort of allocation between sales and transportation.

A number of commenters are adamant that responsibility for the costs of buying out take-or-pay obligations rests upon the customers that caused the pipeline to incur the obligation. They argue that the pipelines procured gas supplies for the benefit of their existing customers and are experiencing the present take-or-pay problems due to efforts to augment supply and meet their service obligations.

3. *Commission response.*—a. Decision not to promulgate Part B. We continue to believe that current and future take-or-pay obligations could possibly impede development of a more competitive gas market. In our April 10, 1985 Statement of Policy we responded to the information obtained through the Notice of Inquiry and our own observations of the gas market. We delineated the basic approach we intended to adopt toward solving the take-or-pay problem. As the comments to the NOPR point out, many producers and pipelines are currently renegotiating contracts under the guidance of the Policy Statement.

All segments of the industry responded to this portion of the rule. While virtually all commenters agree that take-or-pay obligations remain a problem for the industry, they are clearly unhappy with the safe harbor proposal as an additional means to resolve it. Many feel it is unworkable, or inadequate. Others are concerned that it will hinder, or even halt, the contract renegotiation that is underway between pipelines and producers. Many fault the requirements for eligibility as too rigid or mechanistic. Finally, many commenters urge us not to implement the proposed safe harbor rule, or to maintain the status quo.

As we stated briefly in the beginning of this section the imposition of a generic rule to handle take-or-pay

buyouts at this time will not improve the take-or-pay problem and may actually aggravate the situation. In particular, we have no wish to upset current renegotiations. Therefore, in light of the many concerns raised by the written comments and at the public hearing, we will not promulgate Part B as proposed. Instead, and as requested by a number of commenters, we reaffirm our April 1985 Policy Statement. We shall clarify that those guidelines also apply to settlements of future take-or-pay obligations.

We note that pipelines have been successful in buying out past incurred take-or-pay liabilities in a number of instances. See Table C-1 below. [Table omitted]

These arrangements appear to have provided the parties the greatest flexibility to deal with some particularly difficult contractual problems. Accordingly, we have determined that the proven course at the present time is to take no substantive action in this area.

b. Conditioning Producer Access to Transportation

Some commenters, mainly pipelines and local distribution companies, have suggested the Commission consider addressing existing high-cost take-or-pay "problem contracts" as an alternative means of removing the distortions of rolled-in pricing. The Commission has before it in other dockets specific petitions which variously urge it to declare certain take-or-pay provisions in high-cost gas contracts void and unenforceable as against public policy, or to approve pipeline purchase cut-back programs. In addition, many commenters have urged the Commission to require producers to waive take-or-pay claims as a condition to the producer obtaining open and non-discriminatory transportation by interstate pipeline. The Commission has declined to seek to follow this approach. As the reasons were detailed in the discussion of the transportation rules above, the explanation for the decision will not be repeated here.

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